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March/May 2016

Stability Creates Instability

Talk to anyone baby-boomer age or older about families and you will hear complaints about the extremes modern parents go to protect their children. Today's toddlers will never get a bruised face from a coffee table at home, because a rubber bumper surrounds the edges. There clearly are fewer furniture accidents these days, so we are not going to argue the point, but we also should recognize that toddler behavior will differ going forward. Assuming there are no sharp edges in the world, they likely will be more reckless, perhaps leading to accidents more severe than a furniture bruise. Adding the stability of the rubber bumper creates future instability through rash behavior.

This insight was applied to economics by the late Hyman Minsky, a professor at Washington University in St. Louis and Bard College. Minsky originated what is known as the "Financial Instability Hypothesis," a line of thought useful in trying to understand economic cycles. Minsky's thought has been discussed in recent writings by Randall Wray, a professor at Bard College, and Paul McCulley, an economist who worked at Pimco. The basic idea is that financial stability changes behavior. Because of the stability, businesses and consumers feel confident taking on more debt and assuming more risk; these changes create instability.

The U.S. economy and financial markets in the late 19th century were a no-rubber-bumper world.

There were frequent booms, busts, depressions and fast recoveries. That age of commercial capitalism, with modest operating capital loans provided by banks, gave way to an age of finance or industrial capitalism in the early 20th century.

In industrial capitalism, large scale, expensive capital projects were financed through investment banks selling securities in the financial markets that were bought by national and international investors. The seeming risk reduction from the ability to buy relatively small amounts of liquid securities encouraged investor risk-taking, culminating in the speculative boom in the 1920s. The stability of liquid financial markets led overconfident investors to create instability through margin debt.

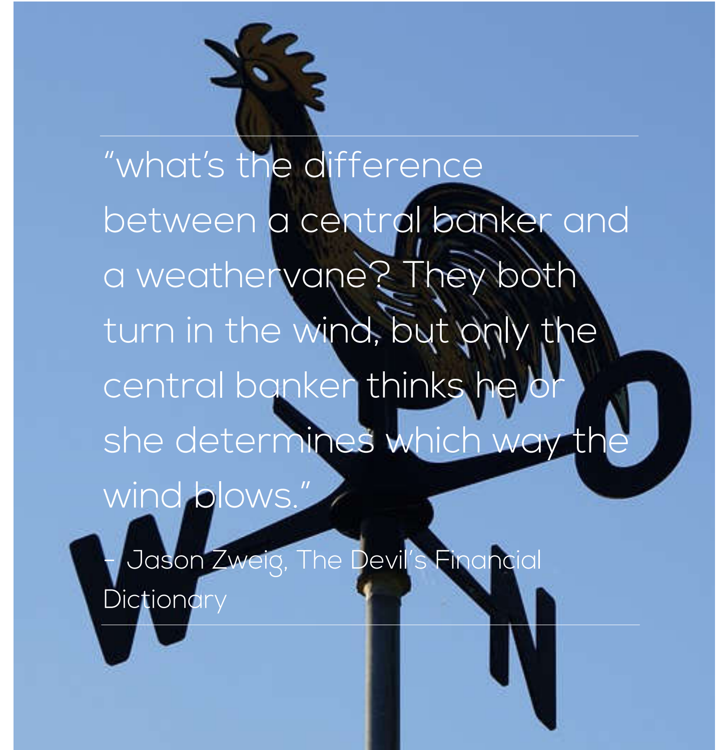
The ensuing Great Depression gave rise to the New Deal and what Minsky called managerial-welfare state capitalism, in which large corporations, labor unions, the government and Federal Reserve worked in concert to promote economic stability and job creation. The relative stability of the Post–World War II decades promoted hubris among government managers trying to fine-tune the economy. What followed

was the stagflation of the 1970s. The economic breakdowns of the 1970s led to what Minsky called money manager capitalism, in which hedge funds, endowments, pension managers and other large pools of capital vigorously compete with one another for returns; this competition can manifest itself in increasingly risky behavior.

In the lead-up to the global financial crisis in 2007-09, these institutional investors took on incredible levels of leverage. The large capital pools also were fraught with "agency" problems, in which those directing other people's money have incentives to benefit themselves in the short run to the long-term detriment of their investors. Minsky did not live to see his theory become reality, but the collapse of the mortgage derivatives market and Lehman bankruptcy were a clear indication that he was onto something.

Central banks around the world now are the fretful parent putting rubber bumpers on the corners of the economic furniture. Despite the boom of the 1990s, the Fed provided easy money in fear of the potential Y2K computer problem. When the tech bubble burst early this century, the Fed lowered interest rates to levels not seen for several decades, helping to fuel the real estate boom. Since the global financial crisis, central banks, through quantitative easing, have sent rates to very low and even negative levels. Any minor dip in the stock market leads to calls for the Fed to step in and save us again.

We used to have a recession and bear market every four years or so. Since the Fed decided to start saving us from ourselves, though, the cycle seems to be longer in time but exaggerated in size. The market top before the global financial crisis occurred *seven and three quarters* years after the market top before the tech bust. Those two bear markets, though, were the most severe in the U.S. since the Great Depression. While history does not necessarily repeat, we do not believe that is a coincidence. Bubbles are always clear in retrospect. Many have told us how obvious the tech and real estate bubbles were; it seems that nobody lost money in those bear markets. We now stand eight and a half years



from the top before the global financial crisis and, by many measures, the U.S. stock market is as highly valued or more so than it was then. Unilever recently sold bonds yielding all of 0.08 percent. Does anyone believe this is normal, that it does not reflect some kind of excess in the system?

Perhaps it is the intention of the central banks to spur economic growth through low interest rates. If so, it is not working. While the stock market has tripled, the current U.S. economic recovery may be one of the longest since World War but it is *by far* the weakest, as measured by cumulative GDP growth. The Federal Reserve is trying to protect us from economic decline but, through low interest rates, is punishing savers and those on a fixed income. In response, investors assume more risk to chase returns. The results are historically high stock market valuations unsupported by real growth in the economy.

The one thing recent history proves is that the Fed is no guarantor against either bear markets or recessions. As with any over-protective parent, the central banks, trying to avoid small problems, may be creating bigger ones.